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      INR-00   ITC-01   LAB-01   VCIE-00  NSAE-00  ISN-00   OMB-00
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TREASURY FOR BALIN

E.O. 12958: DECL: 09/02/2019
TAGS: ECON EFIN IS
SUBJECT: ISRAEL'S FISCAL OUTLOOK

Classified By: Economic Counselor David Burnett for reasons 1.5 b and d.

¶1. (C/NF) Summary: Israel is likely to meet the 2009 fiscal conditions for U.S. loan guarantees signed at the last Joint Economic Development Group (JEDG) meeting on June 29, but it is less certain that Israel will meet the 2010 expenditure conditions for FY2011 loan guarantees. The country faces an uncertain medium-term fiscal outlook and rising debt volumes during 2009-10 and past 2011. There is potential for rising costs of debt financing in 2010 and 2011 as it rolls over a large volume of foreign debt and issues new debt to cover its 2010 budget deficit. If the costs of financing unguaranteed bonds is too high for Israel, it may draw from U.S. guarantees, which Ministry of Finance officials reported was a "definite possibility" in 2010. Rating agencies report that international debt markets do not have an accurate understanding of how much in loan guarantees is available to Israel, and if and when Israel will face settlement deductions in the guarantee program. Continued messaging could clarify the facts of the program and avoid potential adverse market reaction to Israeli or U.S. policy action. End Summary.

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Fiscal targets in sight for 2009; uncertain in 2010
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¶2. (C/NF) On July 16, Israel passed its 2009-10 budget, authorizing 248.2 billion NIS ($62.05 billion) of expenditures in 2009, and 256.0 billion NIS ($64.0 billion) in expenditures in 2010. The permitted budget deficit will be 44 billion NIS ($11 billion) and 43 billion NIS ($10.75 billion) billion in 2009 and 2010, respectively. In 2009, Israel will likely meet spending and budget deficit targets agreed to in the conditions for FY2010 and FY2011 loan guarantees. Nominal spending will increase by 5.35%, and with yearly inflation expected to be roughly 2.5% to 3%, real spending will likely be below the 3.05% cap agreed to at the 2009 JEDG. The nominal budget deficit cap, even in the unlikely scenario of -1.5% growth, will also likely be below the 6% target agreed to at the JEDG.

¶3. (C/NF) Israel's ability to meet its 2010 expenditure target depends largely on inflation. Although the budget outlined a 3.05% real increase in expenditures (not the 1.7% increase agreed to at the JEDG), Israel's binding targets raise nominal spending by 3.15%. If 2010 inflation is 1.45% or higher, real spending will be within the 1.7% target written into U.S. loan guarantee conditions. Currently,

Israel's markets expect 1.5% to 2% inflation in 2010, although historically, the market has been off by as much as 1% in estimating inflation one year in advance. Israel looks likely to meet its deficit target in 2010, and will likely be below the 5.5% deficit target agreed to at the JEDG.

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Israel's Debt-to-GDP ratio likely to rise through 2015
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¶4. (C/NF) With near zero growth expected in 2009, 1% to 2% growth expected to 2010, and comparatively large projected budget deficits for both years, the Ministry of Finance projects that Israel's debt-to-GDP ratio will rise from 78.3% in December 2008 to 84% by end-2009 and 87% by end-2010. After 2011, Israel's fiscal path is highly uncertain. Under the current "glide path" of Israel's long-term budget commitments, Israel's debt-to-GDP ratio will likely rise in both slow and high-growth scenarios, albeit at different rates. The Bank of Israel projects that, if Israel resumes 4% growth after 2011, the debt-to-GDP ratio will slowly rise to 91% by 2015, and continue to increase slowly thereafter. Alternatively, if growth registers at 2% after 2011, Israel's debt-to-GDP ratio will cross 100% in 2014, rise to 103% in 2015, and continue to quickly rise thereafter. Historically, the "threshold" after which market participants began to withdraw from Israeli bond markets (seen in 1988, 1994, and 2003) on fiscal concerns has been 100% of GDP, although this may no longer be such a strong marker as global debt-to-GDP ratios are set to rise in the near term. The Ministry of Finance, however, insists that Israel will be able to control spending by "crunching" the budget each year, where it forces spending cuts in each year's budget to keep the debt-to-GDP ratio on a downward path. The ability of the Ministry to consistently "crunch" the budget in the medium-term, however, may be compromised by a perceived loss of political clout and control over the budget displayed during this spring's drafting cycle.

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2010 to be a more "difficult" year for deficit financing
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¶5. (C/NF) As of August 2009, Israel has roughly NIS 574 billion ($161 billion) in public debt, one-quarter of which is external and denominated mostly in U.S. dollars. 45% of total external debt is guaranteed by the United States through a number of successive programs dating back to 1985. Another 28% of Israel's external debt is floated through concessional State of Israel bonds to the Diaspora community, while the remaining 20% is unguaranteed. The spread on unguaranteed Israeli debt over comparable U.S. Treasury notes is 262 basis points. Israel plans to float another unguaranteed issuance in mid-September, and is currently considering underwriters.

¶6. (C/NF) The Israeli Ministry of Finance Debt Management Unit reports that it must roll over roughly NIS 70 billion ($19 billion) in debt in each of 2010 and 2011, mostly due to the impending maturity of long-term debt floated during the mid-1990s and two large U.S.-guaranteed external issuances from the 1980s. Of the NIS 70 billion to be rolled over, Israel must raise external dollar-denominated funds to cover roughly NIS 10 billion ($2.6 billion) of maturing external debt in 2010, and NIS 5 billion ($1.3 billion) in 2011. In addition to maturing debt, Israel must also raise NIS 39 billion ($10.3 billion) in new debt in 2010, and a comparable (but as of yet undefined) sum in 2011, to cover its budget deficit. In total, Israel must raise roughly $30 billion in 2010 and 2011 off local or international debt markets.

¶7. (C/NF) When asked about Israel's ability to raise $30 billion in debt per year for the next two years, the Debt Management Unit responded that the next two years will be "difficult." In addition to external rollovers, Israel is looking to finance some of its fiscal deficit externally in 2010 due to relatively low projected liquidity on domestic

debt markets. To cover Israel's need for foreign currency, the Unit will first look to issue external unguaranteed bonds, and then draw Diaspora bonds, which it estimates can provide a maximum of $2 billion in debt next year, but will more likely provide roughly $1 billion. If Israel views the costs of financing unguaranteed bonds as too high, it will also draw from U.S. guarantees, which the Unit reported was a "definite possibility" in 2010. Even if it draws U.S. guarantees, the Unit reported that Israel will likely see its costs of financing rise, as demand for Israeli debt will likely fall from 1) a rise in the supply in outstanding Israeli government securities; 2) higher interest rates in Israel; 3) higher investor appetite for more risky assets such as equities; and 4) fiscal and inflation concerns in Israel. The Debt Management Unit sees a similar outlook for 2011, although Israel is only required to roll over $1.3 billion in external debt that year. The Unit sees a return to growth and fiscal prudence in 2010-11 as critical for its ability to fund Israel's yearly deficits at a reasonable cost.

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U.S. support "important" to Israel's credit rating
but value of loan guarantees misunderstood
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¶8. (C/NF) Senior credit rating analysts report that, although Israeli's "A" credit rating relies primarily on the strength of it's economic institutions and a favorable growth outlook. U.S. support, both explicit and implicit, helps create "sustained low risk" of an Israeli default, even in the likely medium-term scenario of rising debt volumes. Rating agencies believe that the current U.S.-Israel loan guarantee program provides Israel "considerable backup" if it faces rising debt servicing costs, but note that the large amount of Israeli external debt already backed by U.S. guarantees, and the implicit promise of U.S. support if Israel faces economic difficulties is an even larger factor in Israel's rating. Analysts explained that Israel could potentially be upgraded if its geopolitical situation improved, both through a final peace agreement with the Palestinians and a resolution to the Iran nuclear issue.

¶9. (C/NF) Rating analysts and market participants in Israel note, however, that Israeli debt markets have an "incomplete understanding" of the U.S.-Israel loan guarantee program. Press reports from the June 2009 JEDG led many participants to believe that the U.S. had "re-approved" the loan guarantee program, adding $600 million in guarantees to be used by Israel. In fact, the 2009 JEDG only created conditions for the FY2010 and FY2011 guarantees already in place as part of the $9 billion 2003 Loan Guarantee Commitment Agreement (LGCA), and did not allot additional guarantees to Israel. Confusion also exists as to the amount of guarantees available to Israel - some quote $3.8 billion, others quote $4.4 billion, while still others quote that Israel has $3.148 billion available. Many market actors also do not understand that the full $3.148 billion may not be available to Israel due to settlement deductions. In reality, 1) Israel currently has $3.148 billion in U.S. guarantees available before settlement deductions for immediate draw; 2) $666 million will be available if Israel meets 2009 and 2010 conditionality agreed to at the 2009 JEDG; and 3) the $3.148 billion figure is subject to settlement deductions, which have not been taken since 2005, and have not yet been determined by the USG.

¶10. (C/NF) Comment: In meetings with foreign and domestic market analysts, Treasury and Emboffs worked to clear up some of the confusion, but continued messaging is necessary to clarify the facts about the loan guarantee program. If debt markets remain uncertain over the amount of guarantees available to Israel or the plausible scope of settlement deductions, they may respond unfavorably in the event of an Israeli draw or USG settlement deduction. End Comment.

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